

Cleveland State University
EngagedScholarship@CSU



Cleveland State Law Review

Law Journals

1994

Single-Employer Profit Sharing Plans: Should a Break in Service That Occurs because of a Natural Disaster Result in the Forfeiture of a Plan Participant's Nonvested Profit Sharing Benefit

Marie Ellen Haynes

Follow this and additional works at: <https://engagedscholarship.csuohio.edu/clevstlrev>

 Part of the [Labor and Employment Law Commons](#)
How does access to this work benefit you? Let us know!

Recommended Citation

Note, Single-Employer Profit Sharing Plans: Should a Break in Service That Occurs because of a Natural Disaster Result in the Forfeiture of a Plan Participant's Nonvested Profit Sharing Benefit, 42 Clev. St. L. Rev. 509 (1994)

This Note is brought to you for free and open access by the Law Journals at EngagedScholarship@CSU. It has been accepted for inclusion in Cleveland State Law Review by an authorized editor of EngagedScholarship@CSU. For more information, please contact library.es@csuohio.edu.

SINGLE-EMPLOYER PROFIT SHARING PLANS: SHOULD A
BREAK IN SERVICE THAT OCCURS BECAUSE OF A
NATURAL DISASTER RESULT IN THE FORFEITURE OF A
PLAN PARTICIPANT’S NONVESTED PROFIT SHARING
BENEFIT?

I. INTRODUCTION509

II. THE EFFECTS OF A NATURAL DISASTER UPON EMPLOYMENT ... 510

III. PROFIT SHARING PLANS513

 A. *Statutory Requirements*515

 B. *Deferred Plans*516

 1. Employer Contributions517

 2. Employee Contributions519

 C. *Vesting*520

 D. *The Vesting Schedule*521

 E. *The Break in Service Rule*522

IV. INVOLUNTARY TERMINATIONS524

V. COURT DECISIONS REGARDING BREAK IN SERVICE RULES 528

 A. *Post-ERISA: Court Decisions*529

 B. *Avoiding the Break in Service Rule*533

VI. PROPOSED STATUTORY AMENDMENT534

VII. CONCLUSION538

I. INTRODUCTION

Profit sharing benefits are a source of income upon which employees’ rely and place a significant value.¹ Employees value their profit sharing benefits because these benefits enhance their financial security, especially after retirement, by operating as a source of supplementary income.² Depending upon the provisions within a profit sharing plan, an employee can become eligible for profit sharing benefits either during employment or at termination from employment.³ There is, however, no guarantee that employees who would normally be entitled to their profit sharing benefits at termination, will

¹See I.R.C. §§ 61(a)(1), 401(a) (West 1994); see also Thomas E. Wood, *Setting Objectives for Profit Sharing Plans*, in GUIDE TO MODERN PROFIT SHARING 17 (1973).

²Robert V. Thonander, *Variations of the Profit Sharing Theme*, in GUIDE TO MODERN PROFIT SHARING 1 (1973).

³*Id.*

indeed receive the total benefit credited to their profit sharing account when they terminate from employment.⁴

Most profit sharing plans provide that the nonvested⁵ portion of an employee's profit sharing benefit can be forfeited when the employee incurs a break in service.⁶ A break in service often results in termination.⁷ Employees can also break their service with an employer by quitting, retiring, dying, becoming disabled, getting laid-off, or being discharged for cause.⁸ Some of these methods of incurring a break from service are voluntary while others are involuntary.⁹ Whether an employee's profit sharing benefit can be forfeited may depend on whether his break in service was voluntary or involuntary.¹⁰

The issue that will be addressed here is whether a break in service that occurs because of a natural disaster should result in the forfeiture of an employee's nonvested profit sharing benefit. Part one will focus on the effects of a natural disaster on employment. Part two will discuss the operation of a profit sharing plan. Part three will examine the nature of involuntary terminations. Part four will evaluate court decisions on how break in service rules should apply to involuntary terminations. Part five will propose a statutory amendment to the break in service rule. The conclusion will then recommend how break in service rules should be applied to terminations which occur as a result of a natural disaster.

II. THE EFFECTS OF A NATURAL DISASTER UPON EMPLOYMENT

A natural disaster is a force of nature-such as a tornado, an earthquake, a hurricane, or a flood-which occurs without any human intervention and

⁴See, e.g., *Tafoya v. Western Conference of Teamsters Pension Trust Fund*, 909 F.2d 344 (9th Cir. 1990).

⁵Nonvested benefits are the portion of an employee's total profit sharing benefit which can be forfeited when the employee terminates from service. See James R. Simone, *Statutory Framework, Language and Fiduciary Responsibility Provisions of ERISA*, in *INTRODUCTION TO QUALIFIED PENSION AND PROFIT SHARING PLANS 1989* 15 (Tax Law & Practice Course Handbook Series No. 289, 1989).

⁶See Retirement Equity Act of 1984, Pub. L. No. 98-397, 98 Stat. 1426 (codified as amended in scattered sections of 26 U.S.C.).

⁷*Van Fossan v. International Bhd. of Teamsters Union Local No. 710 Pension Fund*, 649 F.2d 1243, 1244 (7th Cir. 1981); *Vermeulen v. Central States, Southeast and Southwest Areas Pension Fund*, 490 F. Supp. 234, 235 (M.D. N.C. 1980).

⁸Edwin F. Boynton, *The Vesting Schedule*, in *GUIDE TO MODERN PROFIT SHARING* 79, 82 (1973).

⁹*Whipp v. Seafarers Vacation Plan*, 832 F.2d 853 (4th Cir. 1987) (finding that an employee who had been laid-off was involuntarily terminated); see also *Vermeulen v. Central States, Southeast and Southwest Areas Pension Fund*, 490 F. Supp. 234 (M.D. N.C. 1980) (finding that an employee who quit his job had voluntarily terminated his employment).

¹⁰See, e.g., *Lee v. Nesbitt*, 453 F.2d 1309 (9th Cir. 1971).

cannot be prevented by reasonable care or due diligence.¹¹ Natural disasters usually cause property as well as human damage.¹² In addition, natural disaster can disrupt the lives of individuals as well as the operations of businesses.¹³

As a means of demonstrating good business practice, an employer may plan for the disruptions that a natural disaster can generate by undertaking strategic defenses and managerial approaches that can overcome the unforeseen repercussions of a natural disaster.¹⁴ Planning for the occurrence of a natural disaster has become imperative since there has recently been and may continue to be a rise in the number of occurrences of natural disasters in the United States.¹⁵ These natural disasters have not only increased in volume but also in severity.¹⁶ For example, in 1992 there were a record 1,297 tornadoes in the United States.¹⁷ Also in 1992, Hurricane Andrew and Hurricane Iniki struck South Florida and Hawaii respectively, causing millions of dollars in damage.¹⁸

The United States Small Business Administration's (hereinafter SBA) disaster assistance program made loans totaling \$847 million to the more than 18,000 businesses that were affected by Hurricanes Andrew and Iniki and other disasters.¹⁹ The total SBA loans in 1992 were almost double the \$443 million in loans made by the SBA in the previous year for disaster relief.²⁰ In addition, in the summer of 1993, six states along the Mississippi River experienced major flood damage.²¹ The flood submerged 17,000 square miles of land and caused \$12 billion in property damage.²² Because of these natural disasters, families

¹¹ See BLACK'S LAW DICTIONARY 33 (6th ed. 1990).

¹² Kai Erikson, *After the Flood: How Long Can a Disaster Last?*, NEW REPUBLIC, Sept. 6, 1993, at 14.

¹³ Sharon Nelson, *Prepare for the Worst*, NATION'S BUS., Sept. 1993, at 20; see also Rosalind Resnick, *Protecting Computers and Data*, NATION'S BUS., Sept. 1993, at 26.

¹⁴ ARTHUR A. THOMPSON, JR. & A. J. STRICKLAND III, STRATEGIC MANAGEMENT: CONCEPTS AND CASES 4 (6th ed. 1992).

¹⁵ Stephen Petranek, *The Force of Nature*, LIFE, Sept. 1993, at 31.

¹⁶ *Id.*

¹⁷ *Id.* at 36-37.

¹⁸ Nelson, *supra* note 13, at 21.

¹⁹ *Id.*

²⁰ *Id.*

²¹ Andy Neff, *Flood Victims Keep Weathering the Storm*, NATION'S CITIES WKLY., July 12, 1993, at 1.

²² Erikson, *supra* note 12.

and individuals were displaced from their homes,²³ and thousands of businesses were temporarily or permanently damaged.²⁴

Some businesses in the areas affected by a natural disaster incur structural damage.²⁵ The structural damage, at times, forces these businesses either to cease or to reduce the level of their operations.²⁶ A cessation or reduction in operations frequently leads to a reduction in the number of workers needed by the businesses.²⁷ A significant number of workers can, therefore, become unemployed after an area is struck by a natural disaster.²⁸ For example, Hurricane Andrew caused severe structural damage to 1,200 businesses in South Florida.²⁹ Many of these businesses did not terminate operations because of the structural damage.³⁰ Instead, these businesses continued operating by setting up offices and stores in trailers.³¹ In cases where the trailers were significantly smaller than the original structures, fewer employees were needed to operate the business.³² Thus, a reduction in the areas workforce ensued.³³ One clear aftermath of the natural disaster caused by Hurricane Andrew was the termination of a large number of workers in South Florida.³⁴

Some of those employees who became terminated as a result of natural disasters like Hurricane Andrew had been participants in company sponsored profit sharing plans.³⁵ Whether those employees were entitled to any of their profit sharing benefits upon termination depended upon the terms of their respective plans. Most profit sharing plans specify that employees who are not entitled to their nonvested employer contributed benefits at the date of their

²³*Id.*

²⁴Nelton, *supra* note 13.

²⁵See, e.g., Gus Carlson, *Jobless in South Florida*, MIAMI HERALD, Jan. 3, 1993, at 1k.

²⁶See Nelton, *supra* note 13.

²⁷See Gregg Fields, *Dade's Job Exodus: Labor Force Has Shrunk Since Storm*, MIAMI HERALD, Jan. 1, 1993, at 1C.

²⁸*Id.*

²⁹*Id.*

³⁰See Oscar P. Musibay, *Homestead Businesses Tackle Back*, MIAMI HERALD, Nov. 12, 1992, at KE.

³¹*Id.*

³²Interview with Earl G. Haynes, Store Manager, Rite Aid Pharmacy, in Miami, Fla. (Dec. 24, 1993).

³³*Id.*

³⁴See *supra* note 27.

³⁵Interview with Sonia E. Haynes, Store Manager, Life Uniform Stores, in Miami, Fla. (Dec. 24, 1993).

separation, will forfeit those benefits.³⁶ Moreover, nonvested employer contributed benefits can only be forfeited if the employee is unable to return to work with the plan sponsoring employer one year or more after the break in service commenced.³⁷ On the other hand, an employee cannot forfeit profit sharing benefits derived from his own contributions to a profit sharing plan.³⁸ Employee contributions are always fully vested and, therefore, can never be forfeited.³⁹ Thus, profit sharing plans make a distinction between an employee's right to his own contributions to the profit sharing plan as opposed to the contributions that employers make to profit sharing plans on behalf of their employees.

The profit sharing plan provision which executes a forfeiture upon nonvested employer contributions when an employee incurs a break in service is commonly termed the *break in service rule* (hereinafter the rule).⁴⁰ Currently, under profit sharing plans that include a break in service rule, those employees who have been separated from service for one year or more, due to a natural disaster or otherwise, will forfeit the nonvested portion of their employer contributed profit sharing benefits.⁴¹ In order to illustrate the significance of a loss of nonvested profit sharing benefits to employees, a discussion of the operation of profit sharing as a part of an employee's total compensation package follows.

III. PROFIT SHARING PLANS

A single-employer profit sharing plan is established and maintained by an employer to enable employees or their beneficiaries to participate in the organization's profits.⁴² A profit sharing plan is a program by which employees' receive a share of the employer's profits in addition to their regular compensation.⁴³ With a single-employer plan (hereinafter employer) only one employer, typically an employer operating for a profit, contributes to the

³⁶Stephen T. Lindo, *Introduction to Qualified Plans: ERISA Vesting Rules*, in INTRODUCTION TO QUALIFIED PENSION AND PROFIT SHARING PLANS 193, 217 (Tax Law & Prac. Course Handbook Ser. No. 289, 1989).

³⁷*Id.* at 212.

³⁸Max J. Schwartz, *Introduction to Qualified Plans: Minimum Vesting Standards, and Service Counting*, in INTRODUCTION TO QUALIFIED PENSION AND PROFIT SHARING PLANS 196 at 159, 169 (Tax Law & Prac. Course Handbook Ser. No. 242, 1986).

³⁹*Id.*; see also Simone, *supra* note 5, at 15.

⁴⁰See, e.g., *Cann v. Carpenters Pension Trust*, 662 F. Supp. 501, 502 (C.D. Cal. 1987), *aff'd*, 989 F.2d 313 (9th Cir. 1993).

⁴¹Lindo, *supra* note 36, at 211, 217.

⁴²JOSEPH J. MELONE & EVERETT T. ALLEN, JR., PENSION PLANNING: PENSIONS, PROFIT SHARING, AND OTHER DEFERRED COMPENSATION PLANS 288 (1966).

⁴³Thonander, *supra* note 2, at 1.

plan.⁴⁴ The portion of the organization's profits received by employees are referred to as their profit sharing benefit.⁴⁵ Employees who participate in an employer maintained profit sharing plan are called the plan's participants.⁴⁶ Depending upon the provisions in the profit sharing plan, employees may automatically become plan participants or may elect to become plan participants.⁴⁷

There are three basic types of profit sharing plans.⁴⁸ Profit sharing plans can be cash plans, deferred plans or combination plans.⁴⁹ Cash plans pay out profits directly to employees in the form of cash, checks, or stock as soon as profits are determined.⁵⁰ Deferred plans credit profits to a trust account for the benefit of employees.⁵¹ The funds in a deferred plan are paid at retirement or before retirement under circumstances allowed by the plan.⁵² Under combination plans, part of the profits are paid out currently in cash and the remainder is deferred.⁵³ Only deferred plans and the deferred component of combination plans will be discussed here since only these two plans employ break in service rules.

Employers customarily compensate employees for the jobs they perform.⁵⁴ Profit sharing is a fringe benefit⁵⁵ that is not generally distributed at the same time that an employee's regular compensation is paid.⁵⁶ Instead, employers typically provide profit sharing benefits to employees in order to accomplish certain organizational objectives that are not produced or sufficiently provided

⁴⁴Cf. Richard D. Brown, *Pension and Profit Sharing Plans Distinguished*, in INTRODUCTION TO QUALIFIED PENSION AND PROFIT SHARING PLANS 1989 81, 92 (Tax Law & Prac. Course Handbook Ser. No. 289, 1989); I.R.C. § 414(f) (West 1994) (defining multi-employer plans).

⁴⁵See Robert L. Meyer, *Profit Sharing Compared with Pensions*, in GUIDE TO MODERN PROFIT SHARING 7, 9-10 (1973).

⁴⁶A plan participant is "an employee, or former employee, whose service gives or has given rise to accru[ed] . . . benefits, whether or not [the employee] vests under [the] plan." RICHARD A. WESTIN, LEXICON OF TAX TERMINOLOGY 503 (1984).

⁴⁷Brown, *supra* note 44, at 123.

⁴⁸MELONE & ALLEN, *supra* note 42, at 288.

⁴⁹*Id.*

⁵⁰*Id.*

⁵¹*Id.*

⁵²*Id.*

⁵³MELONE & ALLEN, *supra* note 42, at 288.

⁵⁴Wood, *supra* note 1, at 18.

⁵⁵A fringe benefit is "a colloquial term used to describe noncash benefits conferred to employees." WESTIN, *supra* note 46, at 300

⁵⁶Wood, *supra* note 1.

for by regular compensation.⁵⁷ One of the primary reasons for implementing profit sharing plans is to attract and retain qualified employees.⁵⁸

A. Statutory Requirements

The structure and terms of a qualified profit sharing plan are dictated by federal laws, specifically, the Internal Revenue Code of 1986⁵⁹ (hereinafter Tax Code) and the Employee Retirement Income Security Act of 1974⁶⁰ (hereinafter ERISA).⁶¹ ERISA was enacted to protect employee rights to retirement benefits while the Tax Code offers tax incentives to employers and employees for employee benefit programs.⁶² In order to institute a profit sharing plan that will obtain preferential tax treatment, the plan must legally qualify as a profit sharing plan.⁶³ "In . . . recent years, other laws not connected with taxation [or employee benefits] have also played a material part in the operation of profit sharing plans."⁶⁴ Among these are laws concerning equal pay,⁶⁵ civil rights,⁶⁶ disclosure,⁶⁷ and reporting.⁶⁸ There are also some state laws which affect profit sharing plans such as those relating to trusts⁶⁹ and the protection of creditors.⁷⁰

⁵⁷Thonander, *supra* note 2, at 2.

⁵⁸Other reasons for implementing profit sharing plans are as follows:

1. To serve as an incentive which can increase employee productivity.
2. To defer current income taxes and accumulate a capital reserve.
3. To maximize the capital reserve through the use of a tax exempt trust.
4. To provide retirement income and benefits for employees in the event of separation from service with the employer prior to retirement.
6. To enhance the company's image as a socially responsible employer.

⁵⁹26 U.S.C. §§ 401-19 (1988).

⁶⁰29 U.S.C. §§ 1001-71 (1988).

⁶¹Schwartz, *supra* note 38, at 161.

⁶²Julie L. Bloss, *ERISA: An Overview for Non-ERISA Attorneys*, A.B.A. J., May 1989, at 72.

⁶³Walter H. Brummund, *Legal Requirements and Considerations*, in GUIDE TO MODERN PROFIT SHARING 23 (1973).

⁶⁴*Id.* at 24.

⁶⁵*See* 29 U.S.C. § 206 (1988).

⁶⁶*See, e.g.*, 42 U.S.C. § 2000e (1988).

⁶⁷*See, e.g.*, 18 U.S.C. § 1905 (1988).

⁶⁸Brummund, *supra* note 63; *see, e.g.*, 29 U.S.C. § 401(a) (1988).

⁶⁹*See, e.g.*, CAL. CIV. CODE § 724 (West 1982 & Supp. 1995); *see also* CAL. PROB. CODE § 6320 (West 1991 & Supp. 1995).

⁷⁰Brummund, *supra* note 63, at 24; *see, e.g.*, CAL. CIV. PROC. CODE § 704.115 (West 1987 & Supp. 1995).

Nevertheless, "it is the federal laws which most influence and control profit sharing [plans]." ⁷¹

The Tax Code specifies minimum standards that a profit sharing plan must meet with regard to eligibility,⁷² vesting,⁷³ benefits,⁷⁴ contributions,⁷⁵ allocations,⁷⁶ and nondiscrimination.⁷⁷ When a plan meets the minimum standards specified by the Tax Code the plan is said to be "qualified" for tax advantages under the Tax Code.⁷⁸ Tax advantages are only afforded to plans which defer payment of compensation (deferred and combination plans).⁷⁹ The Tax Code also regulates the terms and operations of a profit sharing plan.⁸⁰ According to the Tax Code, money must be set aside, by the employer, specifically for the profit sharing plan.⁸¹ The Tax Code also stipulates that the money must be set aside on a recurring basis; that is, the contribution cannot be a one shot deal.⁸² Additionally, even if the employer acquires profits for a given year, the employer can decide not only whether to contribute a share of those profits to the plan, but also how much to contribute.⁸³ Under the Tax Code, the plan must also contain a definite formula for allocating contributions among its participants.⁸⁴ All the provisions of a qualified profit sharing plan are required to appear embodied in a comprehensive document which should be provided to employees.⁸⁵

B. Deferred Plans

Deferred profit sharing plans primarily set aside capital in reserve that can be used by employees for a variety of financial needs.⁸⁶ For example, the

⁷¹Brummund, *supra* note 63, at 24.

⁷²I.R.C. § 401 (West 1994).

⁷³*Id.* § 411.

⁷⁴*Id.* § 401.

⁷⁵*Id.* § 404.

⁷⁶*Id.* § 358(b).

⁷⁷Brummund, *supra* note 63, at 26; *see also* I.R.C. § 401 (West 1994).

⁷⁸Brummund, *supra* note 63, at 26.

⁷⁹*Id.*

⁸⁰*Id.*

⁸¹*Id.*

⁸²*Id.*

⁸³Brummund, *supra* note 63, at 26.

⁸⁴*Id.*

⁸⁵*Id.*

⁸⁶Thonander, *supra* note 2, at 4.

deferred income may be used by employees as their only source of retirement income or the deferred income may supplement other retirement income.⁸⁷ A portion of a plan participant's account may even become available for withdrawal before retirement as long as the participant remains employed with the employer.⁸⁸ In addition, the deferred benefits may serve, after an employee's death, as a source of income for surviving family members.⁸⁹

According to the Tax Code, a deferred profit sharing plan must be embodied in a trust account.⁹⁰ The employer is the donor or creator of the trust, and the employees are the trust beneficiaries.⁹¹ A trustee must be designated or ascertainable in order for the plan to satisfy the legal requirements of a trust.⁹² The trustee may be a corporation, a trust company, or an individual.⁹³

1. Employer Contributions

One of the reasons why employers establish deferred profit sharing plans is to utilize the tax advantages which these plans receive.⁹⁴ For example, employer contributions to the profit sharing trust account are deductible as a business expense.⁹⁵ An employer may treat up to fifteen percent of the total contribution made to the trust account as a business expense.⁹⁶ The amount of the employer contribution can then be deducted from the employer's taxable income.⁹⁷ This deduction will lessen the amount that the employer pays in federal income taxes.

Contributions to the trust account are based on an employer's profits, and are made by the employer.⁹⁸ Typically, at the end of each plan year,⁹⁹ the employer determines the amount of the organization's profits that will be

⁸⁷*Id.*

⁸⁸*Id.*

⁸⁹*Id.*

⁹⁰Brummund, *supra* note 63, at 29.

⁹¹*Id.*

⁹²*See, e.g.*, CAL. PROB. CODE § 6321 (West 1991 & Supp. 1995).

⁹³Brummund, *supra* note 63, at 29.

⁹⁴*Id.* at 27.

⁹⁵Thonander, *supra* note 2, at 2.

⁹⁶I.R.C. § 404(a)(3)(A)(i) (West 1994).

⁹⁷*Id.* § 401(k).

⁹⁸MELONE & ALLEN, *supra* note 42, at 292.

⁹⁹A plan year is any consecutive twelve month period designated by the plan during which the plan participant has completed at least 1,000 hours of service. I.R.C. § 411(a)(5)(A) (West 1994).

contributed to the profit sharing trust account.¹⁰⁰ The employer then decides the basis upon which his contributions to the plan will be allocated to all of the plan's participants.¹⁰¹ The employer's total contribution must be divided to allow each participant's account to be credited with a share of the contribution.¹⁰²

Each participant's share is credited to a separate account, although a separate employee account does not actually exist.¹⁰³ The allocation of employer contributions to the profit sharing account of each employee who participates in the plan is usually based on the level of compensation (wage or salary) of each employee, or a combination of the employee's compensation and years of service.¹⁰⁴ If the employer decides to use compensation as the basis for his allocations, then allocations will be made based on the proportion of each participant's compensation to the total compensation of all the plan's participants.¹⁰⁵ The most popular allocation techniques are those based on compensation.¹⁰⁶ Profit sharing allocations which weigh years of service in their calculations are not as popular since they tend to favor long term employees.¹⁰⁷ Plans which make allocations based on years of service are thus carefully scrutinized by the Internal Revenue Service.¹⁰⁸

The allocation techniques described above are used to ascertain the employee's share of contributed profits for accounting or record keeping purposes.¹⁰⁹ A participant's share of the profit sharing account can be increased by: (1) additional annual contributions made by the employer to the account; (2) interest earned if the funds are invested; (3) appreciation of the funds; and (4) reallocations to remaining participants of funds forfeited by terminated employees.¹¹⁰

¹⁰⁰MELONE & ALLEN, *supra* note 42, at 292.

¹⁰¹*Id.*

¹⁰²*Id.*

¹⁰³*Id.* at 293.

¹⁰⁴*Id.* at 292.

¹⁰⁵A participating employee who earns \$30,000 per year when the total annual compensation for all participants is \$3,000,000 would be credited with 1% of the employer's total annual contribution if compensation is the sole criteria used to allocate employer contributions. MELONE & ALLEN, *supra* note 42, at 292. Under this system, an employer who contributes \$100,000 to the profit sharing trust account would credit \$1,000 to the account of a participant who earns \$30,000 per year. *Id.*

¹⁰⁶*Id.*

¹⁰⁷Brown, *supra* note 44, at 124.

¹⁰⁸*Id.*

¹⁰⁹MELONE & ALLEN, *supra* note 42, at 293.

¹¹⁰*Id.* at 310.

An employee may not be immediately entitled to his share of the employer's profits even though funds have been credited to the trust account on the employee's behalf.¹¹¹ Instead, the plan's provisions will determine when the employee will become entitled to his share of the credited funds.¹¹² The Tax Code, however, has stipulated that a participant's profit sharing benefits derived from employer contributions must be nonforfeitable when the participant attains the normal retirement age.¹¹³ As a result, a plan participant is entitled to all of the funds credited to his account upon reaching the age of 65.¹¹⁴ Employers may, nonetheless, provide in their plans for a distribution of benefits before a participant reaches the age of 65.¹¹⁵

2. Employee Contributions

Under the Tax Code, a trust account created as part of a profit sharing plan may qualify for tax advantages if contributions are made to the trust by the employer or the employees.¹¹⁶ Thus, employees are not required to contribute to a plan in order for the plan to become qualified under the Tax Code.¹¹⁷ Employees are allowed by some plans to make voluntary or matching contributions.¹¹⁸ Profit sharing plans that allow voluntary or matching employee contributions are called thrift or savings plans.¹¹⁹ Employee contributions, like employer contributions, also enjoy tax advantages under qualified profit sharing plans.¹²⁰ The employee can contribute to the plan by designating a portion of earned income to the plan before those earnings are subject to income taxes.¹²¹

Employee contributions are made by way of deductions from pay.¹²² The employer facilitates the pay deduction by withholding the portion of an employee's earnings that have been earmarked for the profit sharing plan.¹²³ No personal income taxes are paid by the employee on the withheld earnings

¹¹¹*Id.* at 293.

¹¹²*Id.*

¹¹³See I.R.C. § 411(a)(West 1994).

¹¹⁴*Id.*

¹¹⁵Brown, *supra* note 44, at 109.

¹¹⁶I.R.C. § 401(a)(1)(West 1994).

¹¹⁷*Id.*

¹¹⁸I.R.C. § 401(m)(3)(A)(West 1994).

¹¹⁹Thonander, *supra* note 2, at 4.

¹²⁰Brummund, *supra* note 63, at 28.

¹²¹Brown, *supra* note 44, at 122.

¹²²*Id.*

¹²³*Id.*

until the funds are distributed to the employee.¹²⁴ The employer then accumulates all the withheld earnings and makes a lump sum payment to the trust account on behalf of all the participating employees.¹²⁵ Employees not only avoid income tax payment on the contributed earnings, but also avoid income tax on funds in the trust account until those funds are distributed to the employee at retirement or upon withdrawal.¹²⁶ The employee also enjoys the benefit of compounded interest¹²⁷ on these tax exempt funds.¹²⁸

C. Vesting

The dollar balance of a profit sharing plan is similar to the dollar balance of a regular savings account, with one exception. Unlike the funds in a savings account, the funds in a profit sharing account are not immediately accessible.¹²⁹ A participant's right to his employer's contributions is determined by the vesting provision within the profit sharing plan.¹³⁰ Vesting is a concept designed to ensure that a participating employee in a profit sharing plan will receive a percentage of his accrued benefit¹³¹ by making some or all of the accrued benefits nonforfeitable.¹³² The employer devises the vesting provision for the profit sharing plan.¹³³ However, the Tax Code has certain minimum vesting standards that must be satisfied.¹³⁴

Depending on the vesting schedule¹³⁵ that the employer utilizes, a participant can be either fully vested or nonvested. A participant who is fully vested is entitled to 100% of his accrued benefit upon termination or upon

¹²⁴*Id.*

¹²⁵*Id.*

¹²⁶Brummund, *supra* note 63, at 27.

¹²⁷"Compound interest" is interest that is paid on both the funds deposited in the account and any interest earned on those funds. See BLACK'S LAW DICTIONARY 286 (6th ed. 1990).

¹²⁸Brown, *supra* note 44, at 122.

¹²⁹MELONE & ALLEN, *supra* note 42, at 294-95.

¹³⁰See I.R.C. § 411(a) (West 1994).

¹³¹Accrued benefits are "those contributions, expressed as a dollar figure or as an annuity beginning at retirement, which [have] been earmarked for a particular participant, and which that employee will receive in whole or in part, but only to the extent he or she has a vested right in them." WESTIN, *supra* note 46, at 6.

¹³²WESTIN, *supra* note 46, at 823.

¹³³Boynton, *supra* note 8, at 82.

¹³⁴I.R.C. § 411(a) (West 1994).

¹³⁵A vesting schedule outlines "various mechanical rates at which vesting of accrued benefits occurs." WESTIN, *supra* note 46, at 824.

reaching the normal retirement age.¹³⁶ A participant who is nonvested is entitled to less than 100% of his accrued benefit upon termination from employment.

D. The Vesting Schedule

Prior to 1986, employers could fashion their vesting schedules after one of three vesting schedules outlined in the Tax Code.¹³⁷ The three vesting schedules were as follows:

1. Ten year cliff vesting;¹³⁸
2. five to fifteen year vesting;¹³⁹ and
3. the rule of forty-five vesting.¹⁴⁰

The Tax Reform Act of 1986¹⁴¹ (hereinafter the Act) amended the vesting schedule requirement and required employers to utilize more rapid vesting schedules in their profit sharing plans.¹⁴² In place of the three vesting schedules which were stipulated before the Act, two more liberal vesting schedules were promulgated.¹⁴³ Congress reduced the number of years of service that counted for vesting because the previous requirements tended to operate to the disadvantage of female workers.¹⁴⁴ The two vesting schedules which can now be adopted are as follows:

1. Five year cliff vesting;¹⁴⁵ and
2. three to seven year graded vesting.¹⁴⁶

¹³⁶Schwartz, *supra* note 38, at 169.

¹³⁷*Id.* at 170.

¹³⁸With a cliff vesting schedule "no vesting is required prior to the completion of ten years of service at which time an employee [would] become 100% vested." *Id.* at 171.

¹³⁹With a five to fifteen year vesting schedule "a participant [would] become vested in increments [depending on the number of years of service]." *Id.*

¹⁴⁰With the rule of 45 vesting schedule "a participant with at least five years of service and whose combined total age and years of service equals or exceeds forty-five [would] become vested [based on the participant's position in a predetermined rate schedule]." *Id.* at 172.

¹⁴¹26 U.S.C. § 411 (1988) (amending the Internal Revenue Code of 1954).

¹⁴²See I.R.C. § 411(a)(2)(West 1994).

¹⁴³*Id.*

¹⁴⁴See Retirement Equity Act of 1984, Pub. L. No. 98-397, 98 Stat. 1426.

¹⁴⁵Five-year cliff vesting is a vesting schedule by which participants must be fully vested in employer contributions after five years of service with the employer. I.R.C. § 411(a)(2)(West 1994).

¹⁴⁶With three to seven year graded vesting, a participant must be vested in employer contributions according to the following table:

Years of Service	Nonforfeitable Vested Percent
3.....	20
4.....	40

Under the new five year cliff vesting schedule, a participant will be entitled to 100% of his employer-contributed benefits after he has worked with the employer for five years.¹⁴⁷ Before the fifth year of service, the participant will not be entitled to any of his employer-contributed benefits.¹⁴⁸

Under the three to seven year graded vesting schedule, a participant who has worked for three years with the employer will be entitled to 20% of his employer-contributed benefits.¹⁴⁹ Between the third and seventh year of service, the percentage of benefits to which the participant will be entitled will increase incrementally until the seventh year when the employee will become fully vested.¹⁵⁰

The two vesting schedules outlined in the Tax Code are only guidelines. An employer can, therefore, implement a vesting schedule which provides for more rapid vesting.¹⁵¹ While an employer has some discretion in determining a plan's vesting schedule, the employer still has to meet the minimum guidelines set by the Tax Code.¹⁵²

E. The Break in Service Rule

The Tax Code stipulates that all years of employment with the employer maintaining the profit sharing plan must be included in computing an employee's years of service.¹⁵³ A period where there is a break in service, however, may be disregarded as a period of employment.¹⁵⁴

5.....60
6.....80
7 or more.....100

Id. § 411(a)(2)(B). For example, an employee who is in a three to seven year graded plan would have a nonforfeitable right to 40% of the benefits credited to his account after four years of service. Therefore, if that employee had accrued benefits totalling \$4,000, the employee would be entitled to \$1,600 at retirement or termination before retirement. If the employee terminated in his fourth year and had not reached the normal retirement age, then the employee would forfeit \$2,400 in nonvested benefits.

¹⁴⁷*Id.* § 411(a)(2).

¹⁴⁸"[A] participant who does not have any nonforfeitable right under the plan to an accrued benefit derived from employer contributions" is called a nonvested participant. *Id.* § 411(a)(6)(D)(iii).

¹⁴⁹*See supra* note 146.

¹⁵⁰*See supra* note 146.

¹⁵¹I.R.C. § 411(a)(2) (West 1994).

¹⁵²*Id.*

¹⁵³Schwartz, *supra* note 38, at 192.

¹⁵⁴*See* Retirement Equity Act of 1984, Pub. L. No. 98-397, 98 Stat. 1426.

A break in service is any vesting computation period¹⁵⁵ of twelve months or more, designated by a profit sharing plan, in which a participant does not complete more than 500 hours of service.¹⁵⁶ There can be no finding of a break in service unless the employee incurs a break in service with the plan-sponsoring employer for at least one year.¹⁵⁷ When a finding is made that a plan participant has incurred a break in service, that participant's years of service accumulated before the break will be disregarded (for vesting purposes) unless that employee returns and completes a year of service with the employer.¹⁵⁸ When a plan disregards prior years of service accumulated before a break in service or denies counting the break period as a period of employment, that plan is applying a break in service rule.¹⁵⁹ A break in service rule cannot apply to participants who are fully vested since no portion of the participants accrued profit sharing benefit can be forfeited. When applied to nonvested participants, a break in service rule can delay a participant from becoming fully vested as well as cause the forfeiture of the plan participant's nonvested benefit.¹⁶⁰

The application of a break in service rule in a profit sharing plan can have far reaching effects. The Tax Code states that a break in service merely causes an employee's prior years of service to be disregarded.¹⁶¹ What the Tax Code fails to state is that all the nonvested profit sharing benefits of a plan participant will be forfeited when those prior years of service are disregarded. The Tax Code also does not specify whether the circumstances that triggered the break should be considered when an employer determines if an employee has incurred a break in service.¹⁶² The Tax Code is also silent as to whether the

¹⁵⁵A vesting computation period is "the period used for determining credited service for vesting purposes . . ." WESTIN, *supra* note 46, at 824.

¹⁵⁶I.R.C. § 411(a)(6)(West 1994).

¹⁵⁷*Id.*

¹⁵⁸Upon the employee's return to covered employment, the employee's pre-break and post break service will generally be required to be aggregated. *See supra* note 6. The employee is also entitled to receive full credit for time spent in the re-entry waiting period of service—that is the first year of service after the employee returns—if any part of the employee's benefit derived from employer contributions was vested or if the number of one year breaks in service was less than the number of years of service completed before the break. *Id.*

¹⁵⁹*See, e.g.,* Cann v. Carpenters Pension Trust, 662 F. Supp. 501, 502 (C.D. Cal. 1987), *aff'd*, 989 F.2d 313 (9th Cir. 1993).

¹⁶⁰*See* Retirement Equity Act of 1984, Pub. L. No. 98-397, 98 Stat. 1426.

¹⁶¹THE PROFIT SHARING COUNCIL OF AMERICA, GUIDE TO MODERN PROFIT SHARING 95 (1973).

¹⁶²I.R.C. § 411(a)(4)(D)(West 1994).

voluntariness of a break needs to be considered by an employer when determining if a separation from service constitutes a break in service.¹⁶³

Thus far, employers and plan administrators have been arbitrarily deciding if an employee has incurred a break in service.¹⁶⁴ Employers and plan administrators have defined the criteria that is being used to make a determination of whether a break in service has occurred.¹⁶⁵ The primary criterion that employers and plan administrators have been applying in determining whether an employee has incurred a break in service is the voluntariness of the break.¹⁶⁶ Thus, whether plan participants will forfeit all their nonvested benefits as a result of a break in service due to a natural disaster may turn on whether the break was voluntary or involuntary. However, a finding that a termination was involuntary may not preclude the application of a break in service rule.¹⁶⁷

IV. INVOLUNTARY TERMINATIONS

Whether a break in service due to a natural disaster is a voluntary or involuntary termination has not been established either by statute or case law.¹⁶⁸ An examination of how the courts have classified breaks in service for other purposes will facilitate the resolution of this issue.

Generally, the courts have found that breaks in service that are the result of circumstances beyond the employees' control are involuntary. For example, in *Whipp v. Seafarers Vacation Plan*,¹⁶⁹ a maritime worker brought an action against his employee vacation benefits plan.¹⁷⁰ The employee incurred a break in

¹⁶³See *id.* § 411(a)(6).

¹⁶⁴See, e.g., *Tafoya v. Western Conference of Teamsters Pension Trust Fund*, 909 F.2d 344, 346 (9th Cir. 1990) (finding a break in service if an employee becomes partially disabled but not if an employee becomes totally disabled).

¹⁶⁵See, e.g., *Knauss v. Gorman*, 583 F.2d 82, 84 (3d Cir. 1978) (defining a break in service as a one year period during which a participant is not in covered employment); *Vermeulen v. Central States, Southeast and Southwest Areas Pension Fund*, 490 F. Supp. 234, 236 (M.D. N.C. 1980) (defining a break in service as any 36 month period during which a participant is not in covered employment).

¹⁶⁶See, e.g., *Bolton v. Construction Laborers' Pension Trust*, 954 F.2d 1437 (9th Cir. 1991) (finding a break in service when an employee terminated employment because of a lay-off); *Van Fossan v. International Bhd. of Teamsters Union Local No. 710 Pension Fund*, 649 F.2d 1243, 1244 (7th Cir. 1981) (finding a break in service when an employee ceased working because of a shoulder injury).

¹⁶⁷See, e.g., *Tafoya v. Western Conference of Teamsters Pension Trust Fund*, 909 F.2d 344 (9th Cir. 1990); see also *Knauss v. Gorman*, 583 F.2d 82 (3d Cir. 1978).

¹⁶⁸See, e.g., I.R.C. § 411(a)(6) (West 1994); see also *Van Fossan*, 649 F.2d at 1246 (applying the arbitrary and capricious standard to determine if a break in service rule was legitimately applied to the circumstance that triggered the employee's termination).

¹⁶⁹632 F. Supp. 1487 (D. Md. 1986), *rev'd*, 832 F.2d 853 (4th Cir. 1987).

¹⁷⁰*Id.* at 1490.

service after he was laid-off, and was unable to find work in the maritime industry for fifteen months.¹⁷¹ The trustees' denied the employee's request for vacation benefits because the plaintiff had incurred a break in service under the plan provisions.¹⁷² The employee alleged that the trustees' denial of his vacation benefits was arbitrary and capricious.¹⁷³ The district court held that the unavailability of jobs in the maritime industry was not of the employee's own doing, therefore, his failure to work during the fifteen month period was involuntary.¹⁷⁴ The district court stated that a break in service, which occurs because of a lay-off, is due to no fault of the employee and is an involuntary termination.¹⁷⁵

Similarly, in *Siles v. ILGWU National Retirement Fund*,¹⁷⁶ an employee brought an action against her pension fund for the invalid application of the pension fund's break in service rule.¹⁷⁷ The employee had been denied her pension benefits because she failed to obtain covered employment¹⁷⁸ after she was laid-off.¹⁷⁹ Although the Ninth Circuit did not find the break in service rule invalid, the court held that the layoff constituted an involuntary termination.¹⁸⁰

Further, in *Tafoya v. Western Conference of Teamsters Pension Trust Fund*,¹⁸¹ a disabled employee sued his pension fund to obtain pension benefits which he had been denied after incurring a break in service.¹⁸² The employee was denied his pension benefits because he had broken his service with the employer following a back injury.¹⁸³ The Ninth Circuit held that the plaintiff was not entitled to his pension benefits because he had indeed broken his service with the employer under the plan's provisions.¹⁸⁴ The *Tafoya* court recognized that the employee's break in service was due to his back injury and, therefore, was

¹⁷¹*Id.*

¹⁷²*Id.*

¹⁷³*Id.*

¹⁷⁴*Whipp*, 632 F. Supp. at 1490.

¹⁷⁵*Id.*

¹⁷⁶783 F.2d 923 (9th Cir. 1986).

¹⁷⁷*Id.* at 929.

¹⁷⁸Covered employment is employment by an employer who has contributed to a multiemployer pension fund. *See, e.g., Cann v. Carpenters Pension Trust*, 662 F. Supp. 501, 502 (C.D. Cal. 1987), *aff'd*, 989 F.2d 313 (9th Cir. 1993).

¹⁷⁹*Siles*, 783 F.2d at 930.

¹⁸⁰*Id.*

¹⁸¹909 F.2d 344 (9th Cir. 1990).

¹⁸²*Id.* at 346.

¹⁸³*Id.*

¹⁸⁴*Id.* at 349.

involuntary.¹⁸⁵ Nonetheless, the circuit court found that the pension fund's failure to consider the involuntariness of the plaintiff's break in service did not render the break in service rule inapplicable.¹⁸⁶

Conversely, a majority of courts have held that breaks in service are voluntary when the break is the result of circumstances which, although beyond the employee's control, did not hinder the employee from performing his job. For example, the district court in *Dudo v. Schaffer*¹⁸⁷ held that the employee's break in service which resulted from a minor back injury was a voluntary break in service.¹⁸⁸ The employee in *Dudo* brought an action against his pension fund after the trustees denied his application for pension benefits.¹⁸⁹ The trustees denied the employee's request for pension benefits claiming that the plaintiff had forfeited his right to any benefits when he incurred a break in service.¹⁹⁰ The break in service arose when the employee stopped working because of a back injury that was bothered by the lifting and bending of his local driving job.¹⁹¹ The district court held that medical evidence showed that the employee was capable of performing the required lifting and bending, therefore, the employee's termination was voluntary.¹⁹²

Court findings on the voluntariness of breaks in service have thus far been based on whether the break was the result of circumstances beyond the employee's control and whether those circumstances rendered the employee incapable of performing his job.¹⁹³ A natural disaster is beyond the control of an employee.¹⁹⁴ A break in service which occurs as a result of a natural disaster is likewise beyond the employee's control. If the natural disaster renders the employee incapable of performing his job, then the succeeding break in service will be involuntary and should be recognized as such. Hence, an employer will need to determine how a break in service rule, if implemented, will apply to involuntary breaks in service which are caused by a natural disaster.

An involuntary break in service due to a natural disaster is unlike other involuntary breaks in service or terminations. For example, an employee who is laid-off only has to contend with seeking other employment. After a natural disaster, employees who were involuntarily terminated as a result of the

¹⁸⁵*Id.* at 348-49.

¹⁸⁶*Tafoya*, 909 F.2d at 348-49.

¹⁸⁷551 F. Supp. 1330 (E.D. Pa. 1982), *aff'd*, 720 F.2d 661 (3d Cir. 1983).

¹⁸⁸*Id.* at 1343.

¹⁸⁹*Id.* at 1331-32.

¹⁹⁰*Id.*

¹⁹¹*Id.* at 1343.

¹⁹²*Dudo*, 551 F. Supp. at 1343.

¹⁹³*Id.*

¹⁹⁴See *supra* note 11.

disaster, in addition to seeking employment, will need to rebuild their lives, homes, and sometimes their communities.¹⁹⁵

Employers are also affected by natural disasters.¹⁹⁶ Many employers have to engage in rebuilding their lives, homes, and businesses after a natural disaster has struck.¹⁹⁷ A natural disaster can cause the termination of a greater number of employees than, for example, a termination due to a disability.¹⁹⁸ Employers, and sometimes employees, also know in advance when employee lay-offs will occur.¹⁹⁹ Both employers and employees can prepare for the consequences of a lay-off. However, a natural disaster frequently occurs without prior warning.²⁰⁰ Little, if any, preparation typically precedes a natural disaster.²⁰¹ Moreover, after a severe natural disaster, employees may not be able to return to work for an indefinite period of time.²⁰²

An employer can forgo applying a break in service rule to employees whose involuntary terminations are the result of a natural disaster. If the rule is waived, then both vested and nonvested profit sharing benefits can be distributed to terminated employees. An employer who decides to exercise a break in service rule will, on the other hand, only be required to distribute vested profit sharing benefits to the employees who were unfortunately terminated as a result of the natural disaster. The nonvested benefits of employees under a plan with a break in service will be forfeited.²⁰³ The forfeited benefits will remain in the profit sharing trust account and will later be allocated and distributed to those employees who were fortunate enough to remain with the employer.²⁰⁴ The remaining employees will, thus, incur a windfall because of the application of the break in service rule.²⁰⁵

Employers can, if they wish, equitably provide for all plan participants' affected by a natural disaster. Court decisions that deal with the issue of breaks in service due to involuntary terminations can assist employers in charting

¹⁹⁵Musibay, *supra* note 30, at KE.

¹⁹⁶*Id.*

¹⁹⁷*Id.*

¹⁹⁸See Fields, *supra* note 27, at 1C.

¹⁹⁹See, e.g., 29 U.S.C. § 2102 (1988) (mandating that employers give employees notice of mass lay-offs).

²⁰⁰Erikson, *supra* note 12, at 15.

²⁰¹Nelton, *supra* note 13, at 20.

²⁰²See Fields, *supra* note 27, at 1C.

²⁰³See Retirement Equity Act of 1984, Pub. L. No. 98-397, 98 Stat. 1426 (codified as amended in scattered sections of 26 U.S.C.).

²⁰⁴MELONE & ALLEN, *supra* note 42, at 310.

²⁰⁵*Id.*

provisions for breaks in service due to a natural disaster.²⁰⁶ Most of the court decisions on break in service rules have been in relation to the application of the rules to multi-employer pension plans.²⁰⁷ Qualified profit sharing plans are one form of pension plan.²⁰⁸ Profit sharing plans are defined contribution plans.²⁰⁹ The other form of pension plan is a defined benefit plan.²¹⁰ The courts' treatment of break in service rules within pension plans will also be applicable to profit sharing plans.

V. COURT DECISIONS REGARDING BREAK IN SERVICE RULES

Prior to the enactment of ERISA, federal courts attempted to avert the inequitable loss of pension benefits by plan participants.²¹¹ The courts' strategy was to impose a standard of reasonableness on the trustees who determine participants' eligibility for pension benefits.²¹² "A denial of benefits would be reversed by the Court if the plaintiff demonstrated that the Trustee . . . had acted in an 'arbitrary and capricious' manner."²¹³

The leading pre-ERISA case that dealt with whether a break in service rule was arbitrary and capricious when applied to an involuntary break in service was *Lee v. Nesbitt*.²¹⁴ In *Lee*, a multi-employer pension trust was established for the benefit of unlicensed seamen.²¹⁵ Under the trust provisions, the trustees were given the discretion to establish requirements governing eligibility for

²⁰⁶See, e.g., *Bolton v. Construction Laborers' Pension Trust*, 954 F.2d 1437 (9th Cir. 1992); *Tafoya v. Western Conference of Teamsters Pension Trust Fund*, 909 F.2d 344 (9th Cir. 1990); *Whipp v. Seafarers Vacation Plan*, 832 F.2d 853 (4th Cir. 1987); *Siles v. ILGWU Nat'l Retirement Fund*, 783 F.2d 923 (9th Cir. 1986); *Dudo v. Schaffer*, 720 F.2d 661 (3d Cir. 1983); *Knauss v. Gorman*, 583 F.2d 82 (3d Cir. 1978).

²⁰⁷See, e.g., *Lee v. Nesbitt*, 453 F.2d 1309 (9th Cir. 1971) (involving employers who were members of the maritime industry).

²⁰⁸*Bloss, supra* note 62.

²⁰⁹Defined contribution plans are plans "that provide[] an individual account for each participant. [The] participant's benefit is determined by the value of his or her account, which is based on the amount of contributions allocated to the account plus any income, expenses and investment gains and losses charged to the account." *Simone, supra* note 5, at 13.

²¹⁰A defined benefit plan is a pension plan "that provides a definite and set formula under which the amount of a participant's pension is determined . . . In defined benefit plans the amount of the employer's contribution is actuarially determined each year . . . [The benefits in this type of pension plan] are guaranteed by [the Pension Benefit Guarantee Corporation]." *Simone, supra* note 5, at 12.

²¹¹See *Van Fossan v. International Bhd. of Teamsters Union Local No. 710 Pension Fund*, 649 F.2d 1243, 1246 (7th Cir. 1981).

²¹²*Id.*

²¹³*Id.* (emphasis added).

²¹⁴453 F.2d 1309 (9th Cir. 1972).

²¹⁵*Id.* at 1310.

benefits.²¹⁶ The trust also had a rule that if a person did not work in covered employment for at least 200 days, that person would incur a break in service.²¹⁷ A break in service would result in the cancellation of the employee's previous pension credits.²¹⁸

In *Lee*, the employee suffered a break in service when he failed to work for 200 days between 1955 and 1957.²¹⁹ The employee did not work during that period because no employment was available.²²⁰ The employee's break in service was, therefore, involuntary. Nevertheless, the break in service resulted in the forfeiture of the employee's credited service, and the loss of his pension benefits.²²¹ The employee claimed that the break in service rule should not have been applied to his involuntary termination and that such an application of the rule by the trustees was unreasonable.²²² The Ninth Circuit held that a break in service rule was not *per se* invalid.²²³ However, the court stated that a determination of whether a break in service rule was applied arbitrarily and capriciously would depend on whether or not the termination was voluntary.²²⁴

A. Post-ERISA: Court Decisions

The arbitrary and capricious standard of review continued to be applied by the courts subsequent to the enactment of ERISA.²²⁵ The standard was illustrated in *Van Fossan v. International Brotherhood of Teamsters Union Local No. 710 Pension Fund*²²⁶ where a 60 year old employee who had accumulated 20.5 years of active service was denied his pension benefits by the plan's trustees.²²⁷ The trustees had denied the employee's application for pension benefits because the employee had not been employed by a covered employer for a

²¹⁶*Id.* at 1310-11.

²¹⁷*Id.* at 1311.

²¹⁸*Id.*

²¹⁹*Lee*, 453 F.2d at 1311.

²²⁰*Id.*

²²¹*Id.* at 1310-12.

²²²*Id.* at 1311.

²²³*Id.* at 1312; *see also* *Bolton v. Construction Laborers' Pension Trust*, 954 F.2d 1437, 1439 (9th Cir. 1992); *Tafoya v. Western Conference of Teamsters Pension Trust Fund*, 909 F.2d 344, 348 (9th Cir. 1990); *Van Fossan v. International Bhd. of Teamsters Union Local No. 710 Pension Fund*, 649 F.2d 1243, 1249 (7th Cir. 1981).

²²⁴*Lee*, 453 F.2d at 1312.

²²⁵*Van Fossan*, 649 F.2d at 1246.

²²⁶*Id.* at 1243.

²²⁷*Id.* at 1245.

period of 156 consecutive weeks.²²⁸ According to the provisions of the pension plan, an employee would incur a break in service and would lose all of his prior credited service if he did not work in covered employment for 156 weeks consecutively.²²⁹

The employee, in *Van Fossan*, had ceased working because of a pain in his shoulder.²³⁰ A shoulder injury, is a condition that would normally constitute an involuntary termination.²³¹ Applying the pre-ERISA arbitrary and capricious standard of review, the Seventh Circuit found that "[a] distinction between voluntary and involuntary breaks in service [is] crucial to determining the arbitrariness of the operation of a given break in service rule."²³² The court stated that no break in service provision was arbitrary and capricious *per se*.²³³ The application of a break in service rule to a circumstance beyond the employee's control, the court stated, would, however, be found to be arbitrary.²³⁴ Furthermore, the court stated that if the break in service of the employee was involuntarily brought about, pre-ERISA case law would support a finding of arbitrariness.²³⁵ The court stated that a ruling to the contrary would "permit [a] break in service rule to . . . effectively eliminate [an] employee's right to a pension."²³⁶

In *Bolton v. Construction Laborers' Pension Trust for Southern California*,²³⁷ the Ninth Circuit reiterated the ruling that whether a break in service rule was invalid would depend on the voluntariness of the break.²³⁸ The employee in *Bolton* was denied his pension benefits because of a break in service due to his inability to find work that qualified under his employer's pension plan provisions.²³⁹ The pension plan in *Bolton* was funded solely by employer contributions.²⁴⁰ The court held that under a plan funded solely by employer contributions, pension benefits could reasonably be denied to an employee who failed to work the minimum number of years required by the pension

²²⁸*Id.*

²²⁹*Id.* at 1244.

²³⁰*Van Fossan*, 649 F.2d at 1244.

²³¹*See, e.g.,* Tafoya v. Western Conference of Teamsters, 909 F.2d 344, 346 (9th Cir. 1990).

²³²*See, e.g.,* *Van Fossan*, 649 F.2d at 1248.

²³³*Id.* at 1249.

²³⁴*Id.*

²³⁵*Id.*

²³⁶*Id.* at 1248.

²³⁷954 F.2d 1437 (9th Cir. 1992).

²³⁸*Id.* at 1440.

²³⁹*Id.* at 1438.

²⁴⁰*Id.* at 1439.

plan.²⁴¹ In *Bolton*, however, the employee had worked for more than the minimum number of years required by the plan.²⁴² Moreover, funds had been contributed to the plan by the employer as a result of the employee's efforts.²⁴³ As a result, the court stated that the plan should provide for the determination of whether the employee's break in service was voluntary before denying him benefits.²⁴⁴ The court further stated that the employee could avoid forfeiture of his pension benefits under the break in service rule if he proved that the break in service was involuntary.²⁴⁵

A ruling by a federal court that a termination by a plan participant was involuntary does not guarantee that the court will invalidate the application of a break in service rule to that participant.²⁴⁶ For example, the Ninth Circuit in *Tafoya v. Western Conference of Teamsters Pension Trust Fund*²⁴⁷ held that a pension plan's break in service rule which provided pension benefits following certain involuntary breaks in service, but not others, was valid.²⁴⁸ Under the break in service provision, a plan participant who stopped working because of a total disability would not have a break in service charged to him.²⁴⁹ In contrast, a participant who had at least a two year break in service due to a partial disability would have his previously earned credits cancelled.²⁵⁰

The employee, in *Tafoya*, had sustained an involuntary two year break in service as a result of a back injury.²⁵¹ Unlike the employee in *Lee v. Nesbitt*,²⁵² the employee in *Tafoya* had not completed the minimum period of employment required for vesting.²⁵³ The court, nevertheless, followed its holding in *Lee* that "even if an employee, through no fault of his own, [was] prevented from completing a minimum period of employment, he may be denied . . . pension [benefits]."²⁵⁴ The court further stated that a break in service rule that excluded

²⁴¹*Id.*; see, e.g., *Lee v. Nesbitt*, 453 F.2d 1309, 1312 (9th Cir. 1971).

²⁴²*Bolton v. Construction Laborers' Pension Trust*, 954 F.2d 1437 (9th Cir. 1992).

²⁴³*Id.*

²⁴⁴*Id.*

²⁴⁵*Id.* at 1440.

²⁴⁶*Id.*

²⁴⁷909 F.2d 344 (9th Cir. 1990).

²⁴⁸*Id.* at 346.

²⁴⁹*Id.*

²⁵⁰*Id.*

²⁵¹*Id.*

²⁵²453 F.2d 1309 (9th Cir. 1971).

²⁵³See *Tafoya*, 909 F.2d at 349.

²⁵⁴*Id.* at 348 (quoting *Lee v. Nesbitt*, 453 F.2d 1309, 1311 (9th Cir. 1972)) (emphasis added).

a small percentage of involuntarily terminated employees would not be viewed as arbitrary.²⁵⁵

The court's ruling in *Knauss v. Gorman*,²⁵⁶ further demonstrates how a break in service rule may be upheld when applied to an involuntarily terminated employee.²⁵⁷ In *Knauss*, an employee brought an action to recover pension benefits denied him on account of the application of a break in service rule.²⁵⁸ The employee in *Knauss* lost his job when his employer went bankrupt.²⁵⁹ The trustees denied the employee's claim for pension benefits because the employee had incurred a four year break in service.²⁶⁰ The trustees in *Knauss* advanced the argument that the break in service rule was necessary to ensure that there would be a consistent stream of payment for covered employees.²⁶¹ Those continuous payments, according to the trustees, were necessary to pay pension obligations that had accrued on the basis of past service, for which no employer contributions had been made.²⁶² The trustees asserted that the break in service rule was necessary to maintain the financial viability of the plan.²⁶³ The Third Circuit held that the evidence produced by the trustees was insufficient to demonstrate that the break in service rule was necessary to avert insolvency due to any unforeseen distribution of pension funds.²⁶⁴ The court stated, nevertheless, that the application of a break in service rule would be upheld under circumstances where invalidating the rule would result in the pension fund becoming insolvent.²⁶⁵

Despite prior court decisions to the contrary, the court in *Whipp v. Seafarers Vacation Plan*,²⁶⁶ suggested that in order to avoid a finding that a break in service rule is arbitrary and capricious, employers should make a distinction between how the rule will operate in light of voluntary as opposed to involuntary terminations.²⁶⁷ The break in service rule in *Whipp* was implemented "to provide [an] incentive[] for long-term employment in the . . .

²⁵⁵*Id.*

²⁵⁶433 F. Supp. 1040 (W.D. Pa. 1977), *vacated*, 583 F.2d 82 (3d Cir. 1978).

²⁵⁷*Id.* at 1040-41.

²⁵⁸*Id.*

²⁵⁹*Id.*

²⁶⁰*Id.*

²⁶¹*Knauss v. Gorman*, 583 F.2d 82, 90 (3d Cir. 1978).

²⁶²*Id.*

²⁶³*Id.* at 91.

²⁶⁴*Id.* at 91; *see also Tafuya*, 909 F.2d at 348.

²⁶⁵*Knauss*, 583 F.2d at 91.

²⁶⁶632 F. Supp. 1487 (D. Md. 1986), *rev'd*, 832 F.2d 853 (4th Cir. 1987).

²⁶⁷*Id.* at 1494.

industry."²⁶⁸ The district court opined that the plan's failure to distinguish between voluntary and involuntary breaks in service would not encourage members to stay in an industry when there were no jobs available.²⁶⁹ The Fourth Circuit, however, stated that a failure to differentiate between voluntary and involuntary breaks in service would not render a break in service rule invalid.²⁷⁰

B. Avoiding the Break in Service Rule

Some plans have sought to diminish the harsh consequences of break in service rules by suspending the application of the rule during a "grace period."²⁷¹ For example, under the plan at issue in *Cann v. Carpenters Pension Trust for Southern California*,²⁷² a participant could avoid the break in service rule for up to three consecutive years if the participant could not obtain covered employment within that time.²⁷³ The employee in *Cann* was involuntarily unemployed for four years.²⁷⁴ As a result, the employee requested a suspension of the break in service rule.²⁷⁵ The request was denied.²⁷⁶ The employee's prior service credits were disregarded for pension benefit purposes because of the employee's four year break in service.²⁷⁷

In *Cann*, the district court held that "the [trustee's] rule that grace periods for involuntary unemployment [could] only have a length of three years [was] . . . unreasonable on its face."²⁷⁸ The court stated that the application of the rule punished employees for events beyond their control.²⁷⁹ The court further stated that the grace period did not further the interests of the trustees in weeding out transient employees.²⁸⁰ The court noted that an unlimited grace period for involuntary unemployment would have allowed the plan to attract and retain employees as well as avoid penalizing employees for circumstances

²⁶⁸*Id.* at 1493.

²⁶⁹*Id.*

²⁷⁰*Whipp v. Seafarers Vacation Plan*, 832 F.2d 853 (4th Cir. 1987).

²⁷¹*See, e.g., Cann v. Carpenters Pension Trust*, 662 F. Supp. 501, 502 (C.D. Cal. 1987), *aff'd*, 989 F.2d 313 (9th Cir. 1993).

²⁷²*Id.*

²⁷³*Id.*

²⁷⁴*Id.*

²⁷⁵*Id.* at 503.

²⁷⁶*Cann*, 662 F. Supp. at 503.

²⁷⁷*Id.* at 502.

²⁷⁸*Id.* at 504.

²⁷⁹*Id.* at 503.

²⁸⁰*Id.* at 504-05.

beyond their control.²⁸¹ Thus, the three-year grace period provision would not achieve the employer's alleged objective of retaining loyal employees.

VI. PROPOSED STATUTORY AMENDMENT

Profit sharing benefits are earned income.²⁸² No employer contribution is credited to an employee unless the employee performs a service for the employer.²⁸³ Forfeiture of profit sharing benefits, whether vested or nonvested, is forfeiture of earned income.²⁸⁴ Therefore, an employer should not be allowed to deprive an employee of the benefits he has earned without substantial justification.

The principal reason why employers utilize deferred profit sharing plans is to attract and retain qualified employees.²⁸⁵ Since deferred plans have a vesting feature, employees have to remain in the plan for a term of years in order to obtain benefits under the plan.²⁸⁶ Break in service rules are instituted in profit sharing plans to encourage employees to remain with the employer.²⁸⁷ An employer does not have to utilize a break in service rule in his profit sharing plan.²⁸⁸ The rule is widely utilized, nevertheless, because employers believe that employees will remain with the organization in order to collect all their accrued profit sharing benefits.²⁸⁹ A plan that withholds an employee's accrued benefits for voluntary as well as involuntary breaks in service, however, will not encourage employees who could potentially be affected by the rule to remain with the employer.²⁹⁰

²⁸¹*Cann*, 662 F. Supp. at 505.

²⁸²*See* I.R.C. § 61(a)(1) (West 1994). Because some profit sharing benefits are not paid out immediately does not mean that these benefits are not earned.

²⁸³Raymond H. Giesecke, *The Company Contribution*, in GUIDE TO MODERN PROFIT SHARING 37, 39 (1973).

²⁸⁴*See* Retirement Equity Act of 1984, Pub. L. No. 98-397, 98 Stat. 1426 (codified as amended in scattered sections of 26 U.S.C.).

²⁸⁵Thonander, *supra* note 2, at 2.

²⁸⁶I.R.C. § 411(a)(2)(West 1994).

²⁸⁷*See, e.g.*, Whipp v. Seafarers Vacation Plan, 632 F. Supp. 1487, 1493 (D. Md. 1986) (noting trial testimony which revealed that the purpose of the pension plan was to encourage long-term employment).

²⁸⁸*See* Retirement Equity Act of 1984, Pub. L. No. 98-397, 98 Stat. 1426 (stating that a profit sharing plan may utilize a break in service rule).

²⁸⁹*See, e.g.*, Tafoya v. Western Conference of Teamsters Pension Trust Fund, 909 F.2d 344, 348 (9th Cir. 1990) (noting plaintiff's admission that the primary purpose for a break in service rule is encouraging industry loyalty); Whipp, 632 F. Supp. at 1493 (noting that an objective of pension plans is to encourage long term employment).

²⁹⁰*See, e.g.*, Whipp, 632 F. Supp. at 1493.

A natural disaster is unforeseeable.²⁹¹ Employees neither envision being unemployed as a result of a natural disaster nor do they anticipate the period of unemployment lasting for over a year.²⁹² Under these circumstances, a break in service rule unnecessarily punishes displaced employees.²⁹³ The punishment unfolds when employers exercise break in service rules to deny the displaced employees their nonvested profit sharing benefits.²⁹⁴

Employers have been relentless in justifying the application of break in service rules against involuntarily terminated employees.²⁹⁵ Employers contend that the rule ensures that those employees who put the most into the business will get the most out of it.²⁹⁶ Also, employers assert that the rule not only weeds out transient employees but also rewards loyal employees.²⁹⁷ Some employers have also insisted that break in service rules are necessary to protect the very existence of their profit sharing plans.²⁹⁸

Federal courts have acknowledged that break in service rules serve a useful function.²⁹⁹ Even in cases where employees had been involuntarily terminated, all the extenuating circumstances were considered by the court before a ruling was made that the break in service rule was invalid.³⁰⁰ The courts have, nonetheless, recommended that employers make a distinction in their deferred benefit plans between how a break in service rule will operate in the case of voluntary as opposed to involuntary terminations.³⁰¹ The courts have not, however, held that an involuntary termination will automatically render a break in service rule inapplicable.³⁰²

Some employers have voluntarily tried to diminish the negative consequences that a break in service rule can have on involuntarily terminated

²⁹¹See BLACK'S, *supra* note 11.

²⁹²See, e.g., Carlson, *supra* note 25.

²⁹³See, e.g., Whipp, 632 F. Supp. at 1493.

²⁹⁴*Id.*

²⁹⁵See, e.g., Tafoya v. Western Conference of Teamsters Pension Trust Fund, 909 F.2d 344, 348 (9th Cir. 1990) (stating that the use of a break in service rule is a policy choice which trustees are allowed to utilize) (citing Harm v. Bay Area Pipe Trades Pension Plan Trust Fund, 701 F.2d 1301, 1306 (9th Cir. 1983)); Knauss v. Gorman, 583 F.2d 82, 90 (3d Cir. 1978) (alleging financial necessity as the basis for using a break in service rule).

²⁹⁶See, e.g., Knauss, 583 F.2d at 90.

²⁹⁷See, e.g., Whipp, 632 F. Supp. at 1493.

²⁹⁸See, e.g., Knauss, 583 F.2d at 90.

²⁹⁹See Lee v. Nesbitt, 453 F.2d 1309, 1312 (9th Cir. 1971).

³⁰⁰See, e.g., Knauss, 583 F.2d at 90.

³⁰¹Whipp, 632 F. Supp. at 1494.

³⁰²See, e.g., Tafoya, 909 F.2d at 344.

employees.³⁰³ For example, some employers have suspended the operation of the rule for a limited period of time designated as a grace period.³⁰⁴ The courts have not embraced this limited grace period provision.³⁰⁵ Courts have, instead, stated that an unlimited grace period should be offered, if one is to be offered at all.³⁰⁶

The Tax Code currently allows employers to utilize a break in service rule in their profit sharing plans.³⁰⁷ The Tax Code, however, does not give employers precise direction on how the rule should be applied.³⁰⁸ Congress can follow the direction of the federal courts on the issue of the application of break in service rules to involuntary terminations. Court rulings would serve as an appropriate foundation for a congressional amendment to the rule. A congressional amendment should make definitive prescriptions regarding how the rule should be applied. A congressional amendment is necessary because the issue as to whether the rule should apply similarly to voluntary as well as involuntary terminations has not been resolved.³⁰⁹ The federal courts have tried to resolve the issue, but the circuit court decisions conflict with regard to the application of the rule and, therefore, the rule's application remains ambiguous.³¹⁰

Application of the rule would operate to the disadvantage of employees who break their service because of a natural disaster in a similar fashion to the disadvantage that female workers experienced prior to 1986. The years of service prior to a break in service were disregarded by many plans when female workers incurred a break in service due to pregnancy.³¹¹ Congress sought to remedy the discriminatory impact of the vesting schedule on female workers by reducing the number of years an employee was required to work in order to be vested.³¹² Similarly, because of the injustice that will and has resulted from the application of a break in service rule to employees who are involuntarily terminated because of a natural disaster, Congress should amend the rule. Congress needs to make the application of the rule more precise by

³⁰³See, e.g., *Cann v. Carpenters Pension Trust*, 662 F. Supp. 501, 502 (C.D. Cal. 1987).

³⁰⁴*Id.*

³⁰⁵*Id.* at 504.

³⁰⁶*Id.* at 505.

³⁰⁷I.R.C. § 411(a)(6) (West 1994).

³⁰⁸*Id.*

³⁰⁹See, e.g., *Bolton v. Construction Laborers' Pension Trust*, 954 F.2d 1437 (9th Cir. 1992) (evaluating whether a plan should take into account the voluntariness of a participant's break in service).

³¹⁰*Id.*; see also *Knauss v. Gorman*, 583 F.2d 82 (3d Cir. 1978).

³¹¹See Retirement Equity Act of 1984, Pub. L. No. 98-397, 98 Stat. 1426, 1436.

³¹²See *id.*

singling out the factor or factors that will be determinative of whether a break in service has occurred.

Congress should amend the break in service rule to require that the following conditions be considered before the rule is applied. First, employers should consider the circumstances that led to the termination.³¹³ Second, employers should examine how a break in service rule would affect terminated employees. Third, employers should evaluate whether the rule is necessary to ensure the financial viability of their plan.³¹⁴

Congress has tried to mitigate the negative effects of the rule by providing that years of service before a break would count as service credits if the employee returned to service with the employer and completed one year of service.³¹⁵ This provision was premised on employees being able to return to covered employment.³¹⁶ After a natural disaster has struck, an employer may or may not be able to continue operating.³¹⁷ A business that has permanently ceased operations because of a natural disaster will have undergone what is synonymous to a plant closure.³¹⁸ According to the Tax Code, a break in service rule is inapplicable to employees who are terminated as a result of a plant closing.³¹⁹ Thus, employees who are involuntarily terminated because of a plant closure become fully vested; thus, they are entitled to both their vested and nonvested profit sharing benefits.

After a natural disaster, some employers in the affected area may remain in business, but they may operate at a reduced level with a reduced staff.³²⁰ Employees who are terminated by those employers may or may not be able to return to work.³²¹ Even though these businesses continue to function, for the involuntarily terminated employee the effect is the same as if the business had ceased operation. Hence, the employee who cannot return to work, through no fault of his own, is analogous to the employee who is terminated because of a plant closure, and should be treated accordingly. As a result, the Tax Code should make the operation of a break in service rule inapplicable to employees who are involuntary terminated because of a natural disaster.

³¹³See *Whipp v. Seafarers Vacation Plan*, 632 F. Supp. 1487, 1494 (D. Md. 1986).

³¹⁴See, e.g., *Knauss v. Gorman*, 583 F.2d 82, 91 (3d Cir. 1978).

³¹⁵I.R.C. § 411(a)(6) (West 1994).

³¹⁶See Retirement Equity Act of 1984, Pub. L. No. 98-397, 98 Stat. 1426, 1436 (amending the Tax Code, because Congress believed that a one year leave of absence was not sufficient time for female employees to take care of personal matters).

³¹⁷See, e.g., *Musibay*, *supra* note 30.

³¹⁸See 29 U.S.C. § 2101(a)(2)(1988).

³¹⁹I.R.C. § 411(d)(3)(West 1994).

³²⁰See, e.g., *Fields*, *supra* note 27, at 1C.

³²¹See *id.*

Providing statutory exceptions for victims of a natural disaster is not a novel proposition.³²² In fact, The Worker Adjustment and Retraining Act specifically states that employers are not required to give employees notice of a mass lay-off if the lay-off ensued from a natural disaster.³²³ Congress should, thus, amend the Tax Code to require that employers make a distinction in their deferred benefit plans between how a break in service rule will operate in the case of voluntary as opposed to involuntary terminations. The amendment should further bar the application of a break in service rule to employees who are involuntarily terminated as a result of a natural disaster and, through no fault of their own, are unable to return to covered employment.

VII. CONCLUSION

Employees who incur a break in service under an employer sponsored deferred profit sharing plan are in jeopardy of forfeiting their nonvested profit sharing benefits when a natural disaster causes the termination of their employment. These employees will forfeit the nonvested portion of their profit sharing benefits if they incur a break in service and are unable to resume employment with their employer. The Tax Code allows employers to deny employees their nonvested benefits if the employees' incur a break in service. The courts, on the other hand, have generally invalidated the application of break in service rules to involuntarily terminated employees. The courts, however, do not guarantee that in every case where an employee is involuntarily terminated, the break in service rule will be inapplicable.

In order to preclude the forfeiture of nonvested benefits of the victims of natural disasters, Congress should amend the break in service rule. The amendment should prohibit the application of a break in service rule to employees who break their service because of a natural disaster, and as a result are incapable of resuming employment with the employer. With a congressional amendment to the break in service rule in place, the determination of whether an employee is entitled to his nonvested benefits would no longer be left to the discretion of employers or plan administrators. Instead, the amended break in service provision would ensure that employees who have been involuntarily terminated because of a natural disaster, would receive both their vested and nonvested profit sharing benefits.

MARIE ELLEN HAYNES

³²² See 29 U.S.C. § 2102 (1988) (excepting employers from notifying employees of mass lay-offs that will occur due to a natural disaster).

³²³ *Id.*